

2004 FORECAST UTAH TAXABLE SALES

2003 WRAPUP

1. In 2003, taxable sales will be up just 1%.¹ The 1% growth rate is about 2% less than we predicted last year. For the second year in a row business spending failed to turn around. We may be disappointed again, but more evidence exists now that business spending has been improving in the U.S. in the past two quarters. Detracting from the 2003 growth rate was an Iraq war-economic shock that dropped first quarter taxable sales 4 percent. Since the war-impacted first quarter, taxable sales have improved close to a 3 percent year-over-year growth rate. We expect taxable sales will conservatively increase 3.2 percent in 2004. Our models call for a 6 percent growth rate if all the optimistic economic assumptions hold true. However, a couple of economic forces are still creating up headwinds:

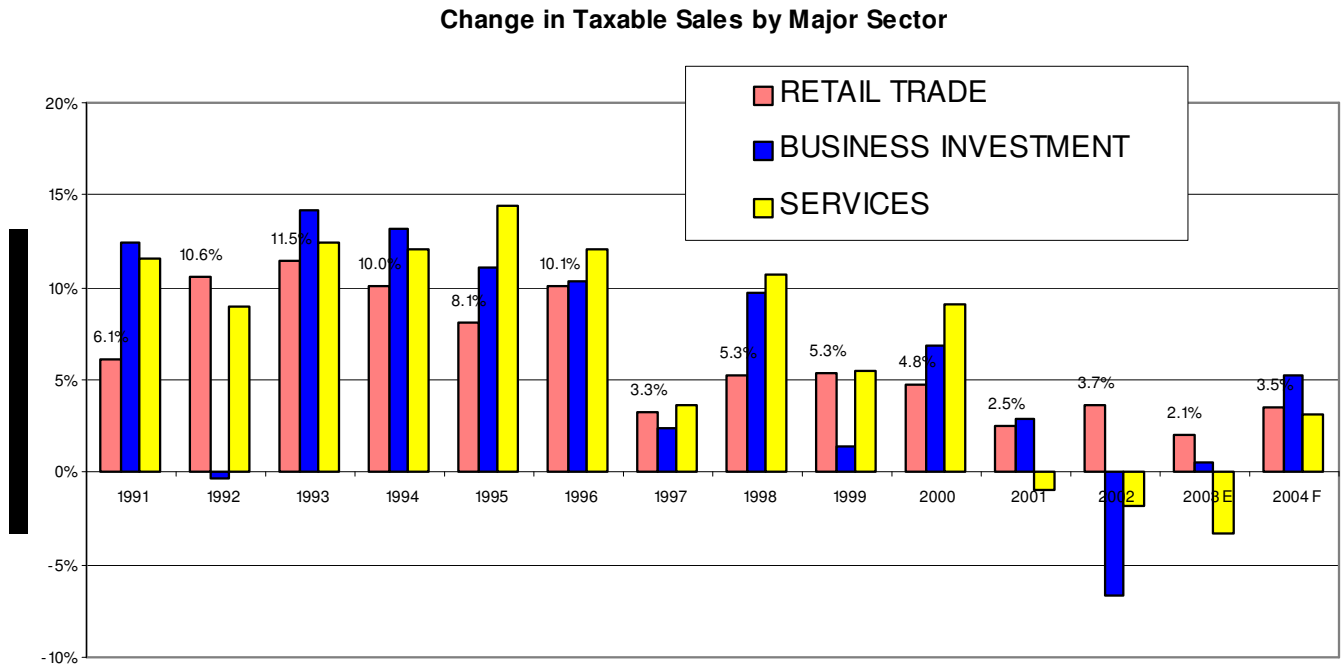
- 1) Job growth has still failed to ignite. Purchasing manager surveys indicate that an upturn here will occur.
- 2) China imports may still be hurting Utah manufacturers more than is being felt in the rest of the nation. But Utah Manufacturing sector taxable purchases should be up nearly 5 percent in 2003.
- 3) In addition, the impact of cheap, high quality goods from China and other Southeast Asian countries has lowered goods inflation, thereby effectively cutting into nominal dollar taxable sales growth.
- 4) Negative impacts from 9/11, terrorism and the Iraq situation still shadow consumer and business confidence, but this should abate as we approach the middle of 2004.
- 5) Finally, mounting sales to consumers over the Internet will cut the sales tax base by 2% in FY2005.

Taxable sales can be dissected into three major components:

- 1) **Retail Trade** at \$18.7 billion, which represents about 57% of taxable sales, will grow 2.1% in 2003, the slowest rate since 1987, about half the growth rate we expected last year, and well below the most recent ten-year average of 6.4%. Our models predict 6 percent is possible in 2004, but we are going with a 3.5 percent growth rate.
- 2) **Taxable Business Investment and Utility Sales**, which, at \$8.1 billion, represent less than 25% of taxable sales, and should grow less than 1% in 2003. We expect these to improve markedly in 2004 between 5% and 9%.

¹ Taxable sales consist of final sales of most tangible personal property in the state. Taxable sales of selected services such as hotel and lodging, automobile leases, amusements and repairs to tangible personal property are also taxable in Utah.

- 3) **Taxable Services**, at \$4.5 billion, will decline 3% in 2003 and represent less than 14% of taxable sales. The 3% decline, the third annual drop in a row, is in contrast to the 7.6% average gains since 1993. For 2004 we expect Taxable Services to grow conservatively 3% and optimistically 7% if all three cylinders (the Utah consumer, the tourist and business spending) percolate together.



Retail Trade. Retail Trade sales rose in double-digits four out of the five times between 1992 and 1996. An end to the economic boom came in 1997 when retail trade sales slowed down to a 3.3% growth rate. Retail trade sales growth improved to 5.3% in 1998 and 1999 and fell back a notch to 4.8% in 2000. In 2001 retail trade sales growth slowed down to a 2.5% growth rate, despite nonfarm wage growth of nearly 4%. The slowdown in job growth, tailing off of construction permit values, U.S. recession and 9-11 attack took their toll on Utah consumer confidence, which fell from 107.6 in 2000 to 95 in 2001. In 2002, zero-rate car loans and historically low mortgage rates temporarily jump-started retail sales to a 3.7 percent growth rate. During the first 9 months of 2003, retail trade increased only 1.6 percent compared to 2002. Anticipation of the Iraq war stymied retail trade in the first quarter when consumers and tourists bought 1.4 percent less than they did in 2002's Olympic quarter. Second quarter retail trade improved 3 percent followed by third quarter's respectable 4 percent increase.

Retail Nondurable Goods. Nondurable goods sold by retailers are classified into the following sectors: General Merchandise, Food, Apparel, Eating and Drinking and Miscellaneous Shopping Goods stores. At \$11.9 billion in 2003, Nondurable Retail sales represent 36 percent of all taxable sales. In 2003, sales in this sector should grow only 1.4%. Nondurable goods sales fell 3 percent in the first quarter, partially due to a comparison with the Winter Olympics quarter and also due to the shock of the Iraq war on consumer confidence. General Merchandise store sales,

whose big discount stores are taking market share not only from traditional department stores, but also from Grocery and Miscellaneous Shopping Goods stores, will see gains of almost 6% in 2003. Food store sales, which typically grow less than average due to high competition and smaller price gains, but are now meeting stiff competition from big-box discount department stores, will experience another sales decline, this time by 5% in 2003. Apparel store sales will be up about 1%, much lower than its ten-year average of 5.1%. Miscellaneous Shopping Goods store sales, which grew 6% in 2002, will see an improvement of only 3% in 2003. Intense competition from big discount Department stores as well as Internet sellers has continued to cut into Miscellaneous Shopping Goods store sales. Barring another Middle-East war or major terrorist attack, nondurable retail sales will be up 2.2% in 2004, almost 4 percentage points lower than its 10 year average of 5.9% and slightly worse than the 3.4 percent gain in wages and salaries. Clearly, nondurable retail sales could run up to 4 percent higher in 2004 if all the positive economic news comes to pass. In the U.S., Global Insight is predicting a near 4 percent nominal increase in nondurable goods sales for 2004, quite a bit slower than the 5.6 percent gain in 2003.

Retail Trade - Durable Goods. We classify Retail Durable goods vis-à-vis the general definition of items that last three or more years into three broad sectors: Building and Garden stores, Furniture stores and Motor Vehicle Dealers. These sectors are usually impacted by: 1) changes in the housing starts, 2) movements in interest rates and 3) job growth. Despite declining employment in Utah during 2003, zero-rate auto loans and historically low mortgage rates boosted hard good sales. Residential construction values, which will rise 20% in 2003, will also bolster hard good sales. Building and Garden store sales will up 8% in 2003. While lumber store sales will rise nearly 8%, hardware store sales (including some big-box types) will be up 9%. Paint, Glass and Wallpaper store sales will approach 10% growth in 2003. All of these respectable growth rates may be eclipsed in 2004, once the new permits turn into homes.

Then, after homes are built, they must be furnished. Furniture and Home Furnishing store sales will see gains only 2% in 2003. Nominal growth for furniture stores (also including electronics and appliances) has been diminished in the last few years by falling prices, partially due to cheaper imports. Since furniture store prices will fall 4 percent again in 2003, this 2 percent nominal increase in Utah furniture store sales really equates to a 6 percent real increase in what the consumer takes home. Due to the 20 percent gains in 2003 residential permit values, furniture store sales should experience a nice boost in 2004. Specifically, furniture and home furnishing store sales will grow nearly 6% in 2003, very close to household appliance store gains of 7%. Radio, TV and Electronic store sales, led by an aggressive newcomer, will see their sales jump nearly 16 percent in 2003. But this chain may be also luring sales away from Computer and Software stores and Record and Tape stores, whose sales will fall about 15 percent in 2003. We suspect that sales at Record and Tape stores may be soft due to aggressive Internet companies enabling consumers to freely download new and old DVD and CD releases. Expect even stronger sales here in 2004, especially if residential construction values and wages and salaries make gains over 2003.

In contrast to last year's near 9 percent growth through the first nine months, Motor Vehicle Dealer sales growth was up less than 2% from January through September 2003. Zero job

growth outweighed zero to near-zero% financing incentives as New Car Dealer sales will only grow 1 percent more in 2003 than in 2002. Used (only) Car Dealer sales may approach 2% growth. Boat Dealer sales will plunge 22%, perhaps due to Utah's dwindling reservoirs. But retiring baby-boomers and low interest rates enabled strong growth for both Recreation and Utility Trailer and Motorcycle Dealers, up 16% and 17%, respectively in 2003. As employment prospects improve in 2004, expect sales for New and Used Car Dealers to improve. Unit sales are expected to rebound back to 92,000 levels and consumers will continue to demand extra accessories or heavier, more expensive SUVs.

Business Investment and Utility Sales. This category includes taxable business-to-business (B2B) purchases of supplies and equipment and business-to-consumer (B2C) sales of utilities and final sales at wholesale trade stores. In 2003, these sectors will comprise slightly less than 25% of all taxable sales (down from a peak of 27% in 2001). Almost 15% are found in goods-producing sectors of Agriculture, Mining and Manufacturing and their Wholesale Trade counterparts, while 10% of taxable sales are in the service producing sectors: Transportation, Communication, and Public Utilities. In six out of eight years between 1991 and 1998 taxable sales in this major sector rose more than 10%. But, following the near 10% gain in 1998 they rose only 1.4% in 1999. Back-to-back 9% gains nationally in order to meet Y2K expectations for business fixed investment in 1999 and 2000 propelled similar purchases in Utah to a near 7% gain in 2000.

The 3% decline in U.S. fixed investment in 2002 led to steeper declines in Utah where capacity utilization might have been higher than average and where high-tech investment dropped more precipitously due to the Olympic buildup. In fact, Utah business investment purchases fell nearly 7% in 2002. Instead of rising nearly 4% as the nation did in 2003, Utah business purchases and utility sales will be up only 0.5 percent in 2003. Through the first nine months these purchases and sales were still down 1.8 percent. Only the very small Agriculture, Forestry and Fishing sector and the larger Manufacturing sector reported purchase gains during the first three quarters of 2003. Manufacturing purchases will be up almost 5% in 2003, a good sign that the goods sector is stabilizing. Purchases in other sectors offset these gains -- Mining (-24%), Construction (-3%), and Wholesale Trade (-2%) during the first nine months of 2003. We are expecting improvement in almost all these sectors by the end of 2003 and into 2004. Global Insight is predicting an 11% gain in U.S. Equipment and Software sales during 2004 in nominal dollars. They are expecting double-digit gains for Computers (19%), Software (11%), Light Vehicles (24%), Aircraft (30%), and Other Transportation equipment (29%). This bodes well for Utah spending on taxable equipment.

In contrast, we expect Transportation, Communications and Public Utility sales and purchases to be flat in 2003 following a 3% drop in 2002. Through the first nine months, sales in this sector were still down 3%. But rate hikes will pump up Public Utility sales in the fourth quarter of 2003 and into 2004. Natural gas rate increases were more than 25%, while Electricity rates rose about 9%. Expect sales in this sector to increase 9% in 2004. However, on the flip side, this gain will diminish disposable income for consumers and add to the costs for Utah's goods producing businesses. While Telephone Communication sales fell 12% during the first three quarters, Mobile Telephone sales growth finally was taking market share away with a 14% gain.

Because prices were falling in this bidding war overall Communication sales were slightly down 0.4% in the first nine months of 2003.

Overall, the mix of Business Investment (up 5%) and Public Utility sales (up 6%) will rise 5.2% in 2004, but more improvement could occur if U.S. business investment grows as Global Insight expects in 2004. Expect taxable Business Investment purchases and Utility sales to run between \$8.5 billion and \$8.8 billion in 2004.

Taxable Services. This sector is an eclectic mix of Utah consumer spending on amusement and personal and financial services, tourist spending for Utah's hotels, resorts and rental cars and business spending on computers and equipment. Driving this sector in our models are Utah wages, Salt Lake City International Airport arrivals and deplanes and U.S. business spending on software and equipment.

Taxable Services, which rose at near break-neck, double-digit gains in the economic expansion between 1990 and 1996, took a breath to less than 4% growth in 1997. In 1998, taxable service growth went back on the fast track by growing almost 11%. But in 1999 slower tourist-related sales brought down taxable-services growth to less than 6%. Improving tourism and surging Y2K demand in the Business Services sector again sped up the growth in overall Services to 9% in 2000. It peaked here at \$4.75 billion in 2000. Slower growth was anticipated in 2001, but the 1% decline was not foreseen. In 2002, even the Winter Olympics boost could not overcome declines in Auto Rentals and Repairs and Business Services, which led to a 2% overall drop in taxable services.

During the first three quarters of 2003, taxable Services sank more than 6% as declines occurred almost across the board in Finance, Hotels, Business, Auto Rentals and Repair, Amusements and Education. We expect fourth quarter to do better bringing 2003 loss to only -3%. In 2004, improving wages, tourism and demand for Computers (see above forecast for U.S. computer spending) will push up Services to \$4.6 billion for a 3% gain. Our modeling suggests a near 7% gain is possible if all of these factors combine in the rebound. Remember the \$4.6 billion level is still 2% below the peak \$4.75 billion record for Services recorded in 2000.

Sales Forecast and Other Public Policy Issues. Several issues affect this very important tax base for Utah state and local governments. In some cases the impacts are not independent of each other. The manner in which these issues are resolved may affect how taxable sales are reported or if they are reported at all.

- 1. 9/11 Impact on Taxable Sales.** Our modeling suggests that 9-11 and its secondary economic affects on tourism, transportation and investment is depressing taxable sales 2.3% per year, by \$810 million in taxable sales and by \$38 million in state sales taxes and more than \$14 million in local sales taxes. In our optimistic sales tax scenario, this negative impact abates somewhat going into FY2005. But so far, it is still seems to be affecting taxable sales late in 2003.

2. **Internet Sales.** Given the fact that surveys put Utahns in the top ten among Internet users and PC purchasers, the inability to tax remote sales is a big issue with respect to the sales tax base. Dr. William Fox et al from University of Tennessee estimated that Internet sales would cost Utah about \$55 million in state and local sales taxes by 2003 and about \$192 million in 2006.² Based on recent quarterly surveys at the U.S. Department of Commerce we calculate the loss will amount to 2% of state and local sales taxes or about \$33 million in fiscal year 2005.³ Local sales tax losses of \$12 million are expected for FY2005.
3. **Streamlined Sales Tax (SST) Developments.** The SST Project continues to progress on the national and the state level. Over 40 states are now participating in the project and about 20 of these states have enacted legislation to bring all or most of their statutes into compliance with the multistate agreement. Major mail order and e-commerce retailers are continuing to volunteer to collect Utah's taxes under the project and we have received several hundred thousand dollars over the last year from such volunteers. Utah's SST legislation will become effective July 1, 2004. The national system is also expected to become fully operational sometime next year. Legislation has been introduced in Congress (H.R. 3134) that would require remote sellers to collect our taxes once that occurs.
4. **North American Industry Classification System (NAICS).** The President's Office of Management and Budget as well as all federal government agencies have adopted a new, updated classification system, which parallels systems in Mexico and Canada, two of our largest trading partners. If new funding were available, the reporting of taxable sales under the NAICS system would be possible by late 2004. With over 150 new industry classifications, some of which are new technology-driven sectors, the distribution of taxable sales under NAICS would give our reports more definition. The new "Information" sector will give the Legislature the option to spread exemptions to B2B purchases in the "new" economy. On the other hand, comparisons of taxable sales by industry to the 1980s and 1990s will be difficult, if not impossible. Systems analysts at the Tax Commission have already begun to prepare files and computer screen for the 6-digit code, what needs to happen is the drive, resources and time allocated to filling in the blanks.

2 Donald Bruce and William Fox, "State and Local Sales Tax Revenue Losses from E-Commerce: Updated Estimates," University of Tennessee, September 2001.

³ Commerce reported Internet B2C retail sales amounted to between 1.3 and 1.7% of total retail sales during the first three quarters of 2003. E-commerce sales were 0.8% of total sales in the second quarter of 2000. See www.census.gov/mrts/www/current.html.

| | <u>1990</u> | <u>1998</u> | <u>1999</u> | <u>2000</u> | <u>2001</u> | <u>2002</u> | <u>2003 E</u> | <u>2004 F</u> |
|--|---------------|---------------|---------------|---------------|---------------|---------------|---------------|---------------|
| RETAIL TRADE | 8,407 | 15,657 | 16,494 | 17,278 | 17,709 | 18,356 | 18,738 | 19,400 |
| | | 5.3% | 5.3% | 4.8% | 2.5% | 3.7% | 2.1% | 3.5% |
| NONDURABLES | 5,757 | 10,006 | 10,492 | 11,091 | 11,367 | 11,769 | 11,939 | 12,200 |
| | | 5.5% | 4.9% | 5.7% | 2.5% | 3.5% | 1.4% | 2.2% |
| General Merchandise | 1362 | 2463 | 2619 | 2797 | 3100 | 3598 | 3799 | |
| | | 5.8% | 6.3% | 6.8% | 10.8% | 16.1% | 5.6% | |
| Apparel | 415 | 757 | 760 | 789 | 802 | 832 | 840 | |
| | | 9.3% | 0.4% | 3.8% | 1.6% | 3.7% | 1.0% | |
| Food Stores | 2161 | 3381 | 3493 | 3641 | 3513 | 3203 | 3052 | |
| | | 3.8% | 3.3% | 4.2% | -3.5% | -8.8% | -4.7% | |
| Eating and Drinking | 861 | 1677 | 1815 | 1906 | 1946 | 2013 | 2053 | |
| | | 7.9% | 8.2% | 5.0% | 2.1% | 3.4% | 2.0% | |
| Miscellaneous Shops | 958 | 1728 | 1805 | 1958 | 2006 | 2123 | 2193 | |
| | | 4.8% | 4.5% | 8.5% | 2.5% | 5.8% | 3.3% | |
| DURABLES | 2,650 | 5,651 | 6,002 | 6,187 | 6,342 | 6,587 | 6,800 | 7,200 |
| | | 4.8% | 6.2% | 3.1% | 2.5% | 3.9% | 3.2% | 5.9% |
| Motor Vehicles | 1577 | 2965 | 3175 | 3390 | 3570 | 3734 | 3797 | |
| | | 6.8% | 7.1% | 6.8% | 5.3% | 4.6% | 1.7% | |
| Building & Gardening | 575 | 1351 | 1476 | 1426 | 1460 | 1487 | 1607 | |
| | | 3.1% | 9.3% | -3.4% | 2.4% | 1.8% | 8.1% | |
| Furniture & Home | 498 | 1335 | 1351 | 1371 | 1312 | 1366 | 1395 | |
| | | 2.1% | 1.2% | 1.5% | -4.3% | 4.1% | 2.1% | |
| BUSINESS INVESTMENT | 3,874 | 7,730 | 7,839 | 8,372 | 8,612 | 8,039 | 8,079 | 8,500 |
| | | 9.7% | 1.4% | 6.8% | 2.9% | -6.7% | 0.5% | 5.2% |
| Agriculture, Forestry & Fishing | 10 | 22 | 27 | 32 | 36 | 38 | 41 | |
| | | -13.2% | 20.5% | 18.5% | 12.5% | 5.6% | 7.5% | |
| Mining | 150 | 259 | 180 | 202 | 210 | 157 | 125 | |
| | | 5.6% | -30.5% | 12.2% | 4.0% | -25.2% | -20.3% | |
| Construction | 203 | 400 | 422 | 408 | 368 | 315 | 309 | |
| | | 3.0% | 5.5% | -3.3% | -9.8% | -14.4% | -1.9% | |
| Manufacturing | 889 | 1601 | 1540 | 1543 | 1583 | 1369 | 1433 | |
| | | 9.3% | -3.8% | 0.2% | 2.6% | -13.5% | 4.7% | |
| Transportation, Communication & Public Utilities | 1351 | 2291 | 2392 | 2742 | 3164 | 3060 | 3061 | |
| | | 11.1% | 4.4% | 14.6% | 15.4% | -3.3% | 0.0% | |
| Wholesale Trade | 1271 | 3157 | 3278 | 3445 | 3251 | 3100 | 3110 | |
| | | 10.5% | 3.8% | 5.1% | -5.6% | -4.6% | 0.3% | |
| SERVICES | 1,829 | 4,122 | 4,350 | 4,745 | 4,701 | 4,615 | 4,461 | 4,600 |
| | | 10.7% | 5.5% | 9.1% | -0.9% | -1.8% | -3.3% | 3.1% |
| Hotels & Lodging | 307 | 551 | 556 | 583 | 597 | 674 | 603 | |
| | | -1.1% | 0.9% | 4.9% | 2.4% | 12.9% | -10.5% | |
| Amusement & Recreation | 194 | 572 | 650 | 714 | 723 | 732 | 731 | |
| | | 5.2% | 13.6% | 9.8% | 1.3% | 1.2% | -0.1% | |
| Personal | 91 | 185 | 190 | 200 | 208 | 212 | 218 | |
| | | 4.3% | 2.7% | 5.3% | 4.0% | 1.9% | 2.8% | |
| Health | 76 | 88 | 86 | 93 | 95 | 104 | 116 | |
| | | -4.1% | -2.3% | 8.1% | 2.2% | 9.5% | 11.8% | |
| Education, Legal & Other | 111 | 195 | 207 | 224 | 225 | 220 | 207 | |
| | | 16.7% | 6.2% | 8.2% | 0.4% | -2.2% | -5.7% | |
| Auto Rental & Repairs | 525 | 1160 | 1169 | 1239 | 1268 | 1211 | 1196 | |
| | | 8.1% | 0.8% | 6.0% | 2.3% | -4.5% | -1.2% | |
| Business | 446 | 948 | 1042 | 1223 | 1158 | 1005 | 989 | |
| | | 22.3% | 9.9% | 17.4% | -5.3% | -13.2% | -1.6% | |
| Finance Insurance | 79 | 423 | 450 | 469 | 427 | 457 | 399 | |
| | | 24.9% | 6.4% | 4.2% | -9.0% | 7.0% | -12.7% | |
| ALL OTHER | 664 | 1,137 | 1,316 | 1,250 | 1,380 | 1,502 | 1,500 | 1,334 |
| | | -4.2% | 15.7% | -5.0% | 10.4% | 8.8% | -0.1% | -11.1% |
| GRAND TOTAL | 14,774 | 28,646 | 29,999 | 31,645 | 32,402 | 32,512 | 32,777 | 33,834 |
| | | 6.8% | 4.7% | 5.5% | 2.4% | 0.3% | 0.8% | 3.2% |

